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IN THE

Supreme Court of the United States.

OCTOBER TERM, 1931.

No. 582.

WOOLFORD REALTY COMPANY, INC., PETITIONER,

v.

J. T. ROSE, COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF GEORGIA.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

MOTION FOR LEAVE TO FILE BRIEF AS AMICI CURIAE AND BRIEF OF AMICI CURIAE.

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WOOLFORD REALTY COMPANY, INC., *Petitioner*,

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J. T. ROSE, Collector of Internal Revenue for the District of Georgia.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

MOTION FOR LEAVE TO FILE BRIEF AS AMICI CURIAE.

May it please the Court:

The undersigned respectfully move this Honorable Court for leave to file the accompanying brief in this case as *amici curiae*.

ALFRED S. WEILL,
HUGH SATTERLEE,
ALBERT S. LISENBY,
Amici Curiae.

IN THE

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J. T. ROSE, Collector of Internal Revenue for the District of Georgia.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

BRIEF OF ALFRED S. WEILL, HUGH SATTERLEE AND ALBERT S. LISENBY AS AMICI CURIAE.

STATEMENT.

This case was decided by the District Court for the Northern District of Georgia upon a general demurrer to the petition. The judgment was affirmed by the Circuit Court of Appeals for the Fifth Circuit. This Court granted a writ of certiorari on January 25, 1932.

The petitioner and the Piedmont Savings Company were affiliated corporations during the year 1927, but were not so affiliated for 1925 and 1926. The two corporations filed separate returns of income for 1925 and 1926, but for the year 1927 filed a consolidated return, which was accepted by the Commissioner of Internal Revenue.

The gross income of the petitioner for 1927, within the meaning of Section 233 of the Revenue Act of 1926, exceeded its deductible expenses and losses, allowed under Section 234, by the amount of $36,587.62, thus leaving the petitioner, without consolidation, with a plus balance of income of

$36,587.62. The deductible items of the Piedmont Savings Company for 1927, allowed under Section 234, exceeded its items of gross income, within the meaning of Section 233, by $453.80, thus leaving it, without consolidation, with an income balance of minus $453.80. In determining the consolidated taxable net income of the two corporations for 1927, the Commissioner offset the minus $453.80 of the Piedmont Savings Company against the plus $36,587.62 of the petitioner, and arrived at a consolidated net income of the two corporations in the amount of $36,133.82, on which the tax was assessed and paid.

The effect of the Commissioner's action, therefore, was to apply net deductions of Piedmont Savings Company allowed under Section 234 of the Revenue Act of 1926, amounting to $453.80, against gross income of the petitioner, since all the deductions of Piedmont Savings Company in excess of $453.80 had already been absorbed in offsetting the full gross income of Piedmont Savings Company.

However, Piedmont Savings Company had also sustained statutory net losses for 1925 and 1926, within the meaning of Section 206 of the 1926 Act, in the respective amounts of $43,478.25 and $410.82. These deductions allowed by the statute the Commissioner refused to take into account in computing the taxable net income on the consolidated return for 1927.

ISSUE.

The issue in this case is whether, in determining the net income for the taxable year 1927 of the affiliated group, consisting of the petitioner and Piedmont Savings Company, deductions for the net losses of Piedmont Savings Company during 1925 and 1926 should be taken into account.

The broad question necessarily involved, however, is whether the net income of a group of affiliated corporations filing a single consolidated income tax return shall be computed as that of a single business enterprise, or whether, notwithstanding affiliation and the filing of a single consolidated return as provided for and permitted by law, the consolidated status

shall be ignored and the affiliated corporations treated as entirely separate enterprises in computing the tax liability under Section 240 of the Revenue Act of 1926.

STATUTES.

The statutory provisions immediately in point are found in the Revenue Act of 1926, as follows:

"Sec. 230. (a) In lieu of the tax imposed by section 230 of the Revenue Act of 1924, there shall be levied, collected, and paid for each taxable year upon the net income of every corporation, a tax at the following rates:* * * ."

"Sec. 232. In the case of a corporation subject to the tax imposed by section 230 the term 'net income' means the gross income as defined in section 233 less the deductions allowed by sections 234 and 206, * * *."

"Sec. 233. (a) In the case of a corporation subject to the tax imposed by section 230 the term 'gross income' means the gross income as defined in sections 213 and 217, * * *."

(Sec. 213 defines gross income generally as gains, profits and income derived from any source whatever, and Sec. 217 defines the net income of nonresident alien individuals.)

"Sec. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: * * *"

(The deductions allowed are listed, being, in general, the expenses and current losses of the business.)

"Sec. 206. (a) As used in this section the term 'net loss' means the excess of the deductions allowed by section 214 or 234 over the gross income, with the following exceptions and limitations: * * *

(b) If, for any taxable year, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount thereof shall be allowed as a deduction in computing the net income of the taxpayer for the succeeding taxable year (hereinafter in this section called 'second year'), and if such net loss is in excess of such net income (com-

puted without such deduction), the amount of such excess shall be allowed as a deduction in computing the net income for the next succeeding taxable year (hereinafter in this section called 'third year'); the deduction in all cases to be made under regulations prescribed by the Commissioner with the approval of the Secretary." * * *

"Sec. 239. (a) Every corporation subject to taxation under this title shall make a return, stating specifically the items of its gross income and the deductions and credits allowed by this title." * * *

"Sec. 240. (a) Corporations which are affiliated within the meaning of this section may, for any taxable year, make separate returns or, under regulations prescribed by the Commissioner with the approval of the Secretary, make a consolidated return of net income for the purpose of this title, in which case the taxes thereunder shall be computed and determined upon the basis of such return. If return is made on either of such bases, all returns thereafter made shall be upon the same basis unless permission to change the basis is granted by the Commissioner.

(b) In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each. There shall be allowed in computing the income tax only one specific credit computed as provided in subdivision (b) of section 236. * * *"

SUMMARY OF ARGUMENT.

The statutory net losses of the Piedmont Savings Company for 1925 and 1926 are allowable deductions on the return of consolidated net income of the petitioner and Piedmont Savings Company for 1927, because:

I. The purpose of a consolidated return, as shown by the legislative, administrative and judicial history of the provisions of the statutes involved, is to treat the gross income and deductions of an enterprise carried on through the instrumentality

of separate but affiliated corporations as those of a single tax computing unit.

II. The consolidated net income of the petitioner and its affiliated company is required to be computed on a consolidated basis, giving effect to the items of gross income and deductions of both members of the group, including the statutory net losses of Piedmont Savings Company. The plain and unambiguous language of the statute places the statutory net losses in the same category as any of the other statutory deductions, and there is no warrant for departing from the statute. To do so would be to levy the tax under no provision of law and create doubt as to its constitutionality. The allowance o the deduction accords with the statute, the fundamental conception of a consolidated return, the decisions of the Board of Tax Appeals and the Circuit Courts of Appeal for the Third and Fourth Circuits, and involves no illogical consequences.

III. The regulations of the Treasury Department in administrative interpretation of substantially similar provisions of law now recognize and allow the deduction claimed.

ARGUMENT.

I.

The history of the statutory provisions for consolidated returns of corporations, the rulings of the Bureau of Internal Revenue in administration of such provisions, and the decisions of the Board of Tax Appeals and the courts with respect thereto, show that the purpose of a consolidated return for affiliated corporations in lieu of separate returns is to treat the income and deductions of an enterprise carried on through the instrumentality of separate corporations as those of a single tax computing unit.

A correct determination of the issue presented requires a consideration of the history of the consolidated returns provisions and the construction placed upon them in practical application by the Bureau of Internal Revenue, the Board of Tax Appeals and the courts.

Prior to the passage of the Revenue Act of 1918 there existed no specific statutory authority for the filing of consolidated returns by affiliated corporations. However, in the exercise of his general authority to promulgate regulations, with the approval of the Secretary of the Treasury, the Commissioner of Internal Revenue promulgated Articles 77 and 78 of Regulations 41, defining affiliation and requiring the filing of a consolidated return for excess profits taxes under the Revenue Act of 1917. The regulations were later validated retroactively by section 1331 of the Revenue Act of 1921.

The Bureau of Internal Revenue and the Congress were persuaded by the results of the Commissioner's administration of the regulations under the 1917 Act that a consolidated return instead of separate returns for affiliated corporations would prevent the arbitrary shifting of income between components of the group and, as well, more properly reflect in law the true income of what was a business unity in fact, thus preventing evasion of taxes, on the one hand, and excessive and arbitrary taxes, on the other. Accordingly, a provision, section 240, was incorporated in the Revenue Act of 1918 specifically providing for a consolidated return in the case of an affiliated group of corporations. In reporting the proposed act to the Senate, the Committee on Finance had this to say in respect of the matter:

> "Provision has been made in section 240 for a consolidated return, in the case of affiliated corporations, for purposes both of income and profits taxes. A year's trial of the consolidated return under the existing law demonstrated the advisability of conferring upon the Commissioner explicit authority to require such returns.
>
> So far as its immediate effect is concerned a consolidation increases the tax in some cases and reduces it in other cases, but its general and permanent effect is to prevent evasions which can not be blocked in any other way. * * * [After discussing methods of evasion.] While the committee is convinced that the consolidated return tends to conserve, not to reduce, the revenue, the committee recommends its adoption not primarily because it operates to prevent evasion of taxes or because of its

effect upon the revenue, but because the principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient both to the taxpayer and to the Government."

(See Senate Report 617, to accompany H. R. 12863, December 6, 1918, Sixty-fifth Congress, 3d session, pages 8 and 9.)

The provision referred to survived the conference and became section 240 of the Act. (Senate Document 385, Sixty-fifth Congress, 3d session, page 27, section 240; House Report 1037, conference report, page 15; 57 Cong. Rec. 255. *Appeal of Farmers Deposit National Bank*, 5 B. T. A. 520, 525; *United States* v. *Cleveland Painesville & Eastern Railroad Co., Inc.*, 42 Fed. (2d) 413.)

Pursuant to the act the Commissioner of Internal Revenue promulgated greatly amplified regulations respecting the filing of consolidated returns and the determination of the consolidated net income of affiliated corporations. (Articles 631–638, Regulations 45 (1920 edition).) Article 631 of the regulations provided:

"The provision of the statute requiring affiliated corporations to file consolidated returns is based upon the principle of levying the tax according to the true net income and invested capital of *a single business enterprise, even though the business is operated through more than one corporation.*" (Italics ours.)

With immaterial changes, the subsequent revenue acts have reenacted the consolidated returns provisions as they were found in the 1918 Act, and the Commissioner has in subsequent regulations under those later acts continued to interpret the purpose of the provisions in the same way as he did under the 1918 Act. (Section 240, Revenue Acts of 1921, 1924, and 1926, and section 141, Revenue Act of 1928; Article 631, Regulations 62, 65 and 69, and Article 31, Regulations 75.)

The rulings of the Bureau of Internal Revenue have consistently adhered to the fundamental conception that the income of a group of several affiliated corporations is really

that of a single enterprise.[1] The same view has been taken by this Court, which, in *Handy & Harman* v. *Burnet*, 284 U. S. 136, 140, said:

> "The purpose of § 240 was, by means of consolidated returns, to require taxes to be levied according to the true net income and invested capital resulting from and employed in a single business enterprise, even though it was conducted by means of more than one corporation."

The Circuit Courts have also, in varying language, accepted the view that the real basis for the consolidated return is the principle of levying the tax according to the true net income of a single enterprise, even though the business is operated through more than one corporation.[2]

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[1] O. D. 415, Cumulative Bulletin 2, p. 226.
A. R. R. 448, " " 4, pp. 314, 315
A. R. R. 624, " " 5, pp. 234, 235
I. T. 1386, " " I–2, p. 32.
I. T. 1600, " " II-1, pp. 184, 185
A. R. R. 2958 " " II-2, pp. 214, 215.
S. M. 1530, " " III–1, pp. 307, 308.
L. O. 1113, " " III–2, pp. 36, 39.
S. M. 2683, " " IV–1, pp. 238, 239.
S. M. 2396, " " IV–1, pp. 240, 241.
S. M. 3384, " " IV–1, pp. 277, 279.
I. T. 2261, " " V–1, pp. 100, 101.
I. T. 2355, " " VI–1, p. 98.
G. C. M. 6640, " " VIII–2, p. 212.

[2] *Ice Service Co.* v. *Commissioner*, 30 Fed. (2d) 230, 231 (C. C. A. 2d).

Flannery & Co. v. *Commissioner*, 42 Fed. (2d) 11 (C. C. A. 3d).

Lavenstein Corporation v. *Commissioner*, 25 Fed. (2d) 375, 376 (C. C. A. 4th).

U. S. v. *Cleveland P. & E. R. R. Co.*, 42 Fed. (2d) 413 (C. C. A. 6th).

W. S. Bogle & Co. v. *Commissioner*, 26 Fed. (2d) 771, 772 (C. C. A. 7th).

Fidelity Nat. Bank & Trust Co. v. *Commissioner*, 39 Fed. (2d) 58, 61 (C. C. A. 8th).

Golden Cycle Corporation et al. v. *Commissioner*, 51 Fed. (2d) 927, 931 (C. C. A. 10th).

Able and illuminating discussions of the fundamental concept underlying the consolidated returns provisions, in thorough harmony with the foregoing views, are contained in the opinions of the Board of Tax Appeals in *Appeal of Gould Coupler Co.*, 5 B. T. A. 499, 513, and *Appeal of Farmers Deposit National Bank*, 5 B. T. A. 520, 525. We shall have occasion later in this brief to quote from these decisions.

In view of the legislative and administrative history of the consolidated returns provisions, there can be no doubt of the underlying purpose and meaning of a consolidated return, but the foregoing statements are confirmed by a recent expression of the Congressional understanding and intent with respect to such returns.

The original draft of the Revenue Act of 1928, as reported from the Committee on Ways and Means to the House, proposed to abolish consolidated returns after 1929. (Union Calendar No. 3, House Report No. 2, 70th Congress, 1st session, page 20, sec. 118.) In the House the provision was stricken out during consideration of the bill, but in the Senate the Committee on Finance inserted a substitute provision, and in its report to the Senate (Calendar No. 987, Senate Report No. 960, 70th Congress, 1st session, page 14) said:

> "The permission to file consolidated returns by affiliated corporations merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise. Unless the affiliated group as a whole in the conduct of its business enterprise shows net profits, the individuals conducting the business have realized no gain. The failure to recognize the entire business enterprise means drawing technical legal distinctions, as contrasted with the recognition of actual facts. The mere fact that by legal fiction several corporations owned by the same stockholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit. To refuse to recognize this situation and to require for tax purposes the breaking up of a single business into its constituent parts is just as unreasonable as to require a single corporation to report separately for tax purposes the gains from its sales department, from its manufacturing activities, from its investments, and from each and every

one of its agencies. It would be just as unreasonable to demand that an individual engaged in two or more businesses treat each business separately for tax purposes."

II.

The consolidated taxable net income of the petitioner and its affiliated company for 1927 is required to be computed on a consolidated basis, giving effect to the items of gross income and deductions of both members of the group, including deductions for the statutory net losses of Piedmont Savings Company, and the court below erred in determining the taxable income of the affiliation as if the companies were filing separate returns.

The error of the court below is based on its misconception of the fundamental theory, purpose and meaning of a consolidated return. It reached an erroneous result because it assumed the premise that the consolidated net income is to be determined by computing the net income of each member of the affiliated group separately in disregard of their affiliated status and then summarizing the results. (Even so, it was not consistent in the application of its own theory.) If the court below was correct the consolidated returns provisions, of long legislative and administrative history, are of no real meaning and accomplish no purpose, because the several affiliated corporations filing a consolidated return would be left substantially as if they had filed separate returns.

It is pertinent to inquire as to precisely what is meant by the determination of net income on a consolidated basis.

The statutory provisions for consolidated returns of corporations, beginning with the Revenue Act of 1918 (section 240) and continuing through the Revenue Acts of 1921 (section 240), 1924 (section 240), 1926 (section 240), and 1928 (sections 141 and 142), have not in terms provided for the method of computation of consolidated net income. The earlier Acts provided, as in the case of the Revenue Act of 1926, that affiliated corporations should or might make a consolidated return of net income, and in such event that the total tax should be computed in the first instance as a unit. The Revenue Act of 1928,

section 141, applying to 1929 and subsequent years, provided merely that an affiliated group of corporations might make a consolidated return, pursuant to regulations prescribing that the tax liability be computed in such manner as clearly to reflect the income, and in such event that the tax should be computed in accordance with such regulations.

From the beginning, therefore, it was necessary for the Treasury Department to promulgate regulations for the determination of consolidated net income. Under the earlier Acts, including the Revenue Act of 1926, the regulations pertaining to consolidated net income were practically identical, and under Section 141 of the Revenue Act of 1928 the corresponding regulation, while more explicit, is to like effect. For convenience the pertinent articles of the regulations under the earlier Acts and under the Revenue Act of 1928, respectively, are here set forth in parallel columns.

Article 635 of Regulations 69, relating to the 1926 Act (to which Article 636 of Regulations 65, Article 636 of Regulations 62, and Article 637 of Regulations 45, relating respectively to the 1924, 1921 and 1918 Acts, are similar), provides in part:

"ART. 635. *Consolidated net income of affiliated corporations.*

Subject to the provisions covering the determination of taxable net income of separate corporations, and subject further to the elimination of intercompany transactions (whether or not resulting in any profit or loss to the separate corporations), the consolidated taxable net income shall be the combined net income of the several corporations consolidated. * * *

Article 31 of Regulations 75, relating to the 1928 Act, provides:

"ART. 31. *Consolidated Net Income.*

(*a*) *Definition.*

Except as otherwise provided in these regulations, the consolidated net income of an affiliated group, which makes or is required to make a consolidated return for any taxable year, shall be the aggregate of the gross income of each of the members of such group less the aggregate of the allowable deductions of each of such members, except that gain or loss will not be recognized upon transactions between members of the group (referred to in these regulations as 'intercompany transactions').

In respect of the statement of gross income and deductions and the several schedules required under Form 1120, a corporation filing a consolidated return is required to prepare and file such statements and schedules in columnar form to the end that the details of the items of gross income and deductions for each corporation included in the consolidation may be readily audited."

(*b*) *Statements and Schedules for Subsidiaries.*

The statement of gross income and deductions and the several schedules required by the instructions on the return must be prepared and filed by the parent corporation in columnar form so that the details of the items of gross income and deductions for each member of the consolidated group may be readily audited. Such statements and schedules shall include in columnar form a reconciliation of surplus for each such corporation, together with a reconciliation of the consolidated surplus. Consolidated balance sheets as of the beginning and close of the taxable year of the group, taken from the books of the group, shall accompany the consolidated return prepared in a form similar to that required for reconciliation of surplus."

The provisions of the present regulations mark no departure from the meaning of previous regulations, for whether the consolidated income be said to be "the combined net income of the several corporations consolidated" or "the aggregate of the gross income of each of the members of such group less the aggregate of the allowable deductions of each of such members," the substance is the same. The several components are merged into one and their separate identities ignored for purpose of computing the "consolidated" income.

Because it throws so much light on the point, we quote at length from the opinion of the Board of Tax Appeals in *Appeal of Gould Coupler Co.*, 5 B. T. A. 499, 513, construing the like provisions of the Revenue Act of 1918:

"This leads to a consideration of what Congress intended when it said in section 240 (a) 'corporations which are affiliated * * * shall * * * make a consolidated return of net income and invested capital for the purposes of this title (income tax) and Title III (profits taxes), and the taxes thereunder shall be computed and determined on the basis of such return,' and, later, 'the total tax shall be computed in the first instance as a unit.' There are two other questions in this case, to be referred to presently, the answers to which also depend upon the construction of this language. Much controversy has arisen over what was meant by the term 'consolidated return,' and there are current two conflicting points of view. One, commonly referred to as the 'legal theory,' maintains that 'consolidation' is a matter of procedure, and the consolidated invested capital and net income should be the sum of the amounts of invested capital and net income, separately computed for each of the several affiliated corporations. Under the other, known as the 'accountant's' or 'economic unit' theory, all inter-company transactions and relationships are eliminated, and a resulting balance sheet and profit and loss statement is obtained which shows the situation as though it were a single business. The advocate of either theory generally insists that his theory should be adhered to consistently in applying section 240."

After reviewing the legislative history of the consolidated returns provisions, the Board proceeded (at p. 515):

"It is plain that the purpose was to circumvent intercompany dealing and accounting practices, of whatever origin or object, through which the invested capital or net income of a corporation in a group under common control might be artificially increased or diminished, with the attendant effect on the taxes upon such company if separately assessed. The so-called 'legal' theory does not fulfill this purpose, nor does the language of the statute support this theory. Section 240 provides that the taxes shall be computed as a unit—not as an aggregate—and upon the basis of a consolidated return. The verb 'to consolidate' means more than to add together; it means to weld into one things that previously were separate. It is derived from the Latin verb *consolidare*, 'to make firm or solid.'

The following definitions are given in Murray's New English Dictionary: 'To make solid, to form into a solid or compact mass; to solidify; to combine compactly into one mass, body or connected whole (territories, estates, companies, administrations, commercial concerns and the like).' The participial adjective 'consolidated' is defined to mean 'made solid, firm or compact; solidified; combined, unified.' The language of section 240 and its legislative background show that Congress used the word 'consolidated' in the sense of 'unified'; there is nothing to indicate they used it in the sense of 'summarized.' Further, it appears from the report of the Finance Commitee that section 240 was recommended after a year's trial of the consolidated return under the 1917 law. This is the time during which Regulations 41, Articles 77 and 78, quoted above, were in force. These articles, it will be noted, provide that the Commissioner may cause an examination of the books of all of the affiliated corporations to be made and a 'consolidated statement' to be made there from. The word 'consolidated' had become current in accounting nomenclature to describe balance sheets, profit and loss statements, and income statements of a group of companies connected with each other by control of stockholdings. Such statements are used in business to show the financial condition or earning power of an undertaking thus constituted after eliminating all the relations of the constituent companies one to another. The consolidated balance sheet represents the ultimate financial position of the group to the outside world after the elimination of the inter-company relationships.

In the light of the genesis of section 240, the object sought to be attained, and the sense in which the word 'consolidated' is used in accounting practice, we are led to the conclusion that Congress intended to require consolidated returns of net income and invested capital arrived at by constructing a single composite invested capital for the group from which duplications and inter-company obligations would have been eliminated, and one statement of net income based on a profit and loss statement from which would have been eliminated all intercompany losses, profits, and other transactions affecting income."

In *Appeal of Farmers Deposit National Bank*, 5 B. T. A. 520, the Board of Tax Appeals was also interpreting section 240

of the 1918 Act, the statutory forerunner of the provisions here involved. It said (p. 523 *et seq.*):

> "Here in the provisions of section 240 (a) we have the key to the whole situation. Underlying these provisions of the statute is a purpose which must be ascertained, and the statute must be construed in such a manner as to make that purpose effective. While the return required by the provisions of section 240 (a) is 'a consolidated return of net income and invested capital,' it is entirely clear from other provisions of the same section that the return contemplated is a return of 'consolidated net income and invested capital.' For instance, Congress has specified that the net income and invested capital of certain affiliated corporations shall be taken out of 'such consolidated net income and invested capital,' and that the remainder of the affiliated group shall be assessed on the basis of the remaining 'consolidated invested capital and net income.'
>
> * * * 'Consolidated net income' means the gross income of the affiliated group, as defined in section 233, less the deductions allowed to the affiliated group by section 234.
>
> Then, by the provisions of the second paragraph of section 240 (a), we find that, in any case in which a taxpayer is assessed upon the basis of a consolidated return, the total tax is to be computed in the first instance as a unit and then assessed upon the respective affiliated companies in such proportions as may be agreed upon among them. That is, the total tax liability of the affiliated group is to be computed and determined upon the basis of the consolidated net income and invested capital, as shown in the return, in the same manner as though the return was that of a single corporate taxpayer filed in accordance with the provisions of section 239. Further than this, the specific credit and exemptions allowed to an affiliated group, for the purpose of computing the income, war-profits, and excess-profits taxes, respectively, are the same specific credit and exemptions allowed to a single corporate taxpayer by the provisions of sections 236, 311, and 312, respectively.
>
> Thus we find from the provisions of section 240 (a) that in any case where two or more corporations are affiliated, within the meaning of the provisions of sub-

division (b) of the same section, a single return setting forth the items of gross income and the deductions of the affiliated group satisfies the requirements of section 239 that every corporation subject to taxation shall make a return; that the tax liability of the affiliated corporations is to be determined upon the basis of the consolidated net income and invested capital, in the same manner as though the tax liability of a single taxpayer was being determined; and that in computing the tax liability of the affiliated corporations as a unit only such specific credit and exemptions are to be allowed as are allowed to a single taxpayer by the provisions of sections 236, 311, and 312. That is, for the purpose of determining the tax liability of the members of an affiliated group, the group is to be regarded and treated as a single corporate taxpayer."

It accordingly appears that the Commissioner of Internal Revenue, in his regulations quoted above at page 13, and the Board of Tax Appeals are in agreement as to the proper method of determining the consolidated net income of an affiliated group, namely, by subtracting from the aggregate of the items of gross income of the group the aggregate of the deductions of the group.

On the principles thus stated there can be no question that the statutory net losses of Piedmont Savings Company for 1925 and 1926 should be included as part of the aggregate of the deductions of the members of the affiliated group from the aggregate of the items of gross income of the members.

Referring specifically to the Revenue Act of 1926, in force during the taxable years, although the provisions of the other Acts are generally similar, Section 239 provides that every corporation shall make a return stating specifically the items of its gross income and the deductions and credits. Section 240 provides that, where affiliated corporations make a consolidated return of net income, the taxes shall be computed and determined upon the basis of such return. Section 232 provides that the term "net income" means gross income less "the deductions allowed by Sections 234 and 206." Section 234 provides for the deduction of business expenses, interest,

taxes, depreciation, etc., and Section 206 provides for the deduction of net losses of the last preceding year or two years. It must be borne in mind that the tax is laid on "net income," a purely statutory concept determined as above provided.

Giving effect to all these statutory provisions, in the light of the principles enunciated in the regulations and by the Board of Tax Appeals, the petitioner computed consolidated net income by subtracting from the aggregate gross income of the affiliated corporations the deductions allowed both under Section 234 and under Section 206, resulting in no taxable net income. On the other hand, the Circuit Court of Appeals, in derogation of the provisions of the statutes, arbitrarily computed consolidated net income by subtracting from gross income only the deductions allowed by Section 234, without taking into account the net losses for 1925 and 1926 allowed as deductions by Section 206,—even by this anomalous process arriving at minus net income in the case of Piedmont Savings Company and at a consolidated net income less than the separate net income of the petitioner.

The following table shows the contrasting computations by the petitioner and by the Circuit Court of Appeals, the figures for net income and net losses being taken from the record and the other figures being assumed for purposes of illustration:

	Woolford Realty Co.	*Piedmont Savings Co.*	*Consolidated or Combined*
A. Computation by petitioner.			
Gross income (Sec. 233)	$136,587.62	$10,000.00	$146,587.62
Deductions			
(Sec. 234)	100,000.00	10,453.80	110,453.80
(Sec. 206)	—	43,889.07	43,889.07
	$100,000.00	$54,342.87	$154,342.87
Net income or *loss* (Sec. 232)	36,587.62	*44,342.87*	*7,755.25*
B. Computation by Circuit Court of Appeals.			
Gross income (Sec. 233)	$136,587.62	$10,000.00	$146,587.62
Deductions (Sec. 234)	100,000.00	10,453.80	110,453.80
Net income or *loss* (Sec. 232)	36,587.62	*453.80*	36,133.82

The language of section 232 is too plain for dispute as to its meaning. It says:

> "In the case of a corporation subject to the tax imposed by section 230 the term 'net income' means the gross income as defined in section 233 less the deductions allowed by sections 234 and 206, * * *."

It is not disputed that the Piedmont Savings Company had statutory net losses within the meaning of section 206 for 1925 and 1926, in the respective amounts of $43,478.25 and $410.82. Section 206 (b) and (c) provide that these "shall be allowed as a deduction in computing the net income." This language is the same in substance as that used in section 234 (a) with respect to any other kind of deductions, such as ordinary and necessary business expenses, interest, taxes, losses, depreciation and the like, which "in computing the net income of a corporation" it is provided by the section "shall be allowed as deductions." The deductions allowed "in computing the net

income" of a corporation by both section 206 and section 234 are equally applicable and to be used. There is clearly no warrant in law for disallowing the deductions on a consolidated return of either those provided in section 206 or those provided in section 234. They are by the Act itself placed in the same category, and the plain, unambiguous meaning of the Act must be ignored if one or the other are not to be allowed as deductions on the consolidated return.

The method used by the petitioner is in accordance with past and present regulations of the Bureau of Internal Revenue and with various published rulings of the Bureau of Internal Revenue,[1] and certainly is the method which must follow as

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[1]Office Decision 415, Cumulative Bulletin No. 2 (1920), p. 226, held: "The income of affiliated corporations which is derived from Government contracts is taxable (except as provided in sec. 240 (a) of the Revenue Act of 1918) upon the basis of the total sum received from that source by the group, and not upon the basis of the separate amount received by each corporation."

Solicitor's Memorandum 2683, Cumulative Bulletin IV–1, (1925), pp. 238, 239, contains this language: "The language of section 240 (a) is specific. It states that 'corporations which are affiliated * * * may make separate returns or, * * * make *a* consolidated return.' This language can mean but one thing; that the group as a whole may render individual corporate returns or that the group as a whole may render *a* consolidated return."

Solicitor's Memorandum 2396, Cumulative Bulletin IV–1 (1925), pp. 240, 241, distinguishes between the mere consolidation of accounts of non-affiliated corporations for purposes of making accurate distribution or apportionment of gains, profits, income, etc., as provided in section 240 (d) of the 1921 Act, a provision found in the other Acts also, and the case of a consolidated return, saying: "The consolidation of accounts in certain cases is 'for the purpose of making accurate distribution or apportionment' of gains, profits, income, etc. But if the returns were to be consolidated there would be no occasion for making any such distribution or apportionment."

As further illustrating the effect of a consolidation and the method to be used in computing the income in such cases, Income Tax Ruling 2261, Cumulative Bulletin V–1 (1926) pp. 100, 101, states: "It is the opinion of this office that the net

inevitable from the fundamental conception of the consolidated returns provisions. It simply assimilates all the items of gross income and deductions of the several members of the affiliated group into a common, combined, consolidated unit, and reaches the net result of the entire enterprise. The method disregards the accident of different branches of the same enterprise being in legally separate corporations, and, therefore, disregards as immaterial the question of which member of the group gave rise to a deduction, or against which member's gross income such deduction is to be applied. The computation involves solely the application of *all* deductions of the group against *all* gross income of the group.

This follows the theory outlined in Law Opinion 1113 of the Bureau of Internal Revenue, Cumulative Bulletin III–2, (1924), 36, 39, in which, with respect to a "net loss" of a member of an affiliated group filing a consolidated return under the 1918 Act, it was held:

> "Section 204 defines a net loss as the excess of the deductions allowed by law, with certain exceptions not here material, over the sum of the gross income plus any tax-exempt interest. Section 240 of the Act and the regulations issued thereunder provide that in the case of an affiliated group the net income on the basis of which the tax is computed and assessed shall be the net income of the group considered as a unit, such net income to be computed by deducting from the consolidated gross income the sum of all deductions to which the members of the group are entitled. *In other words, the net income of the group upon the basis of which the tax is computed and assessed is the amount of the gross income of the group, less all allowable deductions,* and an operating loss of a single member of a group is merely one of the allowable

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income resulting from such a consolidation of the accounts of domestic and foreign corporations will be the total gross income of the domestic and foreign corporations from all sources (eliminating intercompany transactions) less all the allowable deductions (with intercompany transactions eliminated) to which the corporations would be entitled if they were all domestic corporations. * * * Such construction of Section 240 (d) is not in conflict with the provisions of section 240 relating to consolidated returns of affiliated corporations."

deductions from gross income in computing the consolidated net income upon the basis of which the tax is determined and assessed. (Italics ours.)

An illustration of a practical application of the correct principle is shown in the decision of the Board of Tax Appeals in *Appeal of Standifer Construction Corporation*, 4 B. T. A. 525, 552. There the question directly in issue was whether a deduction attributable to a subsidiary, the Home Company, for the extraordinary amortization of war facilities allowed under the 1918 and 1921 Acts should be applicable against the gross income of the Home Company only, or whether it should be allowed to the affiliated group against the gross income of the group. The Board held the deduction not confined to the Home Company, but allowable against the gross income of the whole affiliated group. The *ratio decidendi* of the decision was stated as follows:

"The fourth question presented is whether the amortization deduction, in so far as it relates to the housing facilities of the Home Company, should be allowed only to that company in determining its net income, or should be allowed the consolidated group or to the Standifer Corporation.

It was contended by both the Commissioner and the taxpayer that the solution of this question rests upon the nature of the consolidated return. The question thus presented is whether, in a consolidated group of corporations, the separate entities are obliterated, or whether the deductions allowed each company are to be deducted from the gross income of each company in arriving at its net income, or, in other words, whether it is the net income and invested capital of each of the companies which are to be included in a consolidated return, or whether it is the income and invested capital of the entire group determined as one business in which the separate entities included therein are fused. * * * [After citing *Appeal of American La Dentelle, Inc.*, 1 B. T. A. 575, and *Appeal of Frank G. Shattuck Co.*, 2 B. T. A. 7.]

The language above quoted sets forth our view with respect to the nature and effect of a consolidated return. It must follow that the amortization deduction is a deduction allowable to the affiliated group of corporations

in a consolidated return. This means, under the circumstances of this case, that the amortization deduction with respect to the housing facilities erected, constructed or acquired by the Home Company should be allowed as a deduction in determining the net income to be included in the consolidated return, irrespective of whether in arriving at such consolidated net income the deduction is in the first instance applied to or by the Home Company."

The decision, based on the same reasoning as were the decisions in *Appeal of Gould Coupler Co.*, 5 B. T. A. 499, *supra*, and *Appeal of Farmers Deposit National Bank*, 5 B. T. A. 520, *supra*, was publicly acquiesced in by the Commissioner of Internal Revenue, the adverse party in the case. See Cumulative Bulletin V-2 (1926), pp. 1, 3. It must therefore be regarded as the Departmental view of the fundamental theory applicable to this sort of case, and, if followed here, must necessitate a reversal of the court below and the allowance of the deduction for statutory net losses of Piedmont Savings Company on the consolidated return against the gross income of the affiliated group.

The court below in this case (53 Fed. (2d) 821) and in the case of *Planters' Cotton Oil Co., Inc.* v. *Hopkins*, 53 Fed. (2d) 825, and the Circuit Court of Appeals for the Second Circuit in *Commissioner of Internal Revenue* v. *Ben Ginsburg Company, Inc.*, 54 Fed. (2d) 238, have decided contrary to the principles here advanced. However, the Circuit Court of Appeals for the Third Circuit in *National Slag Co.* v. *Commissioner of Internal Revenue*, 47 Fed. (2d) 846, the Circuit Court of Appeals for the Fourth Circuit in *Burnet, Commissioner of Internal Revenue* v. *Moore Cotton Mills Co.*, 49 Fed. (2d) 59, and the Board of Tax Appeals in a long line of decisions[1] have held in

[1] *Alabama By-Products Corporation*, 18 B. T. A. 919; *Buckie Printers' Ink Co.*, 19 B. T. A. 943; *Pittsburg Gasoline Co.*, 21 B. T. A. 297; *General Box Corporation*, 22 B. T. A. 725; *Arrow Coal & Ice Company*, 22 B. T. A. 1341; *Tolerton & Warfield Company*, 23 B. T. A. 892; *Hawley Investment Company*, 23 B. T. A. 953.

support of our position, although in the recent case of *Bowman Hotel Corporation* v. *Commissioner*, 24 B. T. A. 1193 (December 19, 1931), involving a New York corporation, where venue on appeal would be in the Second Circuit, the Board followed the Second Circuit decision in the *Ginsburg* case, *supra*, rendered November 2, 1931.[1]

The Circuit Court of Appeals for the Fifth Circuit in this case and in the *Planters Cotton Oil Co.* case seems to have been more disturbed by the metaphysical question of whether there can be "minus net income" than anything else. Suffice it to say in this respect that section 232 of the Act makes "net income" (either plus or minus) a purely statutory result of subtracting from the gross income as defined in section 233 the deductions allowed by sections 234 and 206. Obviously in any case where the deductions exceed the gross income the mathematical result is a minus. What is thus settled by statutory definition should not be disputable.

The court also clearly seems to have insisted on the separate identities of the affiliated group and to have computed the income of each member separately instead of on a consolidated basis. It then reached the view that in any case where the deductions under section 234 of a corporation treated separately exceeded that corporation's gross income, the deduction here claimed could not be allowed. But it will be noted that in this case the Commissioner of Internal Revenue and the Circuit Court of Appeals for the Fifth Circuit have allowed the deductions of Piedmont Savings Company under section 234, to the extent that they exceeded the gross income of Piedmont Savings Company and produced an ordinary loss (or "minus"

[1] We have not treated of the decision of the Court of Claims in the case of *Swift & Co.* v. *United States*, 38 Fed. (2d) 365, because it involved a situation under the 1918 Act, governed by language materially different from that we are concerned with, nor of the decision of the Circuit Court of Appeals for the Second Circuit in *Sweets Company of America* v. *Commissioner*, 40 Fed. (2d) 436, which did not at all involve the question of net losses.

net income) of $453.80, to be applied against the income of the petitioner. The effect is the same as if deductions under section 234 of the one company were applied directly against the gross income of the other. If that is permissible, other deductions, namely those defined by section 206, being placed in the identical category by the Act, must be applied in like manner.

The court also erred grievously in its conception that the consolidated returns provisions could not be regarded as permitting a consolidated group to avail itself of deductions for net losses sustained prior to affiliation by a member. This conception is contrary to the present view and regulations of the Treasury Department, as we later show (*post*, p. 29), and erroneously makes the date of incidence of the deduction controlling as to whether it is to be allowed on a consolidated return. But other statutory deductions, heretofore not questioned on a consolidated return, such as interest on bonds and other indebtedness, compensation for services rendered and the like, as well as amortization of war facilities (see *Appeal of Standifer Construction Company*, 4 B. T. A. 525, *supra*), often have their incidence in obligations or contracts entered into by one of the members of an affiliated group at a time prior to the period when it became a member of the affiliation. If the test to be applied to the question of whether this deduction can be allowed on a consolidated return is that of the date of the incidence of the deduction rather than what the law provides, obviously the same test must be applied to other statutory deductions claimed on a consolidated return. But in that event the law itself must be entirely disregarded and we shall have a tax, not levied on net income determined in accordance with Congressional enactments, but levied under no provision of law, and therefore of doubtful constitutionality.

The Circuit Court of Appeals for the Second Circuit, in the *Ginsburg* case, fell into the error of supposing that the members of the affiliated group are to be regarded as separate entities for

the purpose of computing the tax.[1] As this is a misconception of the fundamental purpose of a consolidated return, it requires no attempt at refutation. The Court also, and as its further reason for its decision, seems to have reached the conclusion that, if the net losses of the affiliated member are to be allowed as deductions to the consolidated group, the effect would be to accumulate net losses beyond the limit contemplated, by using a net loss to compute a further net loss. This error arises from a failure to recognize the statutory definition of a net loss as excluding any possibility of the use of a net loss in the computation of a net loss. (See section 206 (a).)

The decision of the Circuit Court of Appeals for the Fourth Circuit in *Burnet* v. *Moore Cotton Mills Co.*, 49 Fed. (2d) 59, involving a question of the statutory exemption or credit, required a construction of identical language with that here involved, and held that the words "shall be allowed as a deduction in computing net income" mean what we have herein argued they mean.

The Board of Tax Appeals has, in its decisions with respect to the question, with the single exception noted *supra* (page 25), proceeded in accordance with both the express provisions of the Act and the fundamental theory of consolidated returns. Its basic decision on the point is that rendered in *Alabama By-Products Corporation* v. *Commissioner of Internal Revenue*, 18 B. T. A. 919, in which (at pages 920 and 921) it said:

> "* * * [The statutory net loss] is, by the plain language of the statute, put in the same category as any other deduction allowed by statute in determining net income

[1] This is contrary in theory to the ruling of the Bureau of Internal Revenue, I. T. 2355, C. B. VI-1 (1927), p. 98, holding that "Where a tax is assessed upon the basis of a consolidated return, and one of the affiliated companies, on the basis of a separate return, would be entitled to the lower rate of tax allowed domestic insurance companies under the provisions of section 246 (a) 1 of the Revenue Act of 1926, no part of the consolidated net income will be taxable at such lower rate unless the group of affiliated corporations as a whole can qualify as a domestic insurance company."

for the taxable year. It is, for 1920, an allowable deduction from the gross income of the corporation which sustained the loss. An operating loss or deficit of one corporation in an affiliated group, or the amount by which its allowable deductions exceeded its gross income, should be reflected in determining the consolidated net income.

The allowable deductions of the Majestic Coal Co. for 1920, including the excess of its 1919 net loss over its 1918 net income, result in a deductible loss for 1920. This loss should be reflected in determining the consolidated net income of the group. *Gould Coupler Co.*, 5 B. T. A. 499; *H. S. Crocker Co.*, 5 B. T. A. 537."

The Circuit Court of Appeals for the Third Circuit in *National Slag Company* v. *Commissioner of Internal Revenue*, 47 Fed. (2d) 846, 847, after observing that "The answer depends upon the nature of a consolidated return for affiliated companies," and that "The statute [net loss section] does not intimate that its provisions are inapplicable to affiliated corporations," and after showing the fundamental theory of consolidated returns to be as we have urged, stated that the deductions of net losses "come directly within the provisions of the statute which are plain, certain and unambiguous," and decided that the question should be resolved as the petitioner here contends.

The grounds upon which the Board of Tax Appeals, the Circuit Courts of Appeals for the Third Circuit and the Fourth Circuit, and this petitioner, reach their conclusions are supported by the law and the long recognized theory of consolidated returns, and, as we shall next show, are recognized by the Commissioner of Internal Revenue in the present Treasury Department regulations as the correct position.

III.

The present regulations of the Treasury Department are in accord with the position of the petitioner, and, as an administrative interpretation, are entitled to great weight.

The provision of the Revenue Act of 1928, section 141, relating to consolidated returns, differs from the provisions

of prior acts in respect to consolidated returns only in three respects relevant to this case: first, it defines differently what corporations may be regarded as affiliated; second, it requires the affiliated corporations which may file consolidated returns to consent, by the filing of such return, to such regulations as the Commissioner may prescribe with respect thereto; and, third, it provides:

> "(b) Regulations.—The Commissioner, with the approval of the Secretary, shall prescribe such regulations as he may deem necessary in order that the tax liability of an affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be determined, computed, assessed, collected, and adjusted in such manner as clearly to reflect the income and to prevent avoidance of tax liability."

The statute makes no change with respect to what constitutes gross income or what constitute allowable deductions of affiliated corporations. Accordingly, it may properly be concluded that such regulations as the Commissioner, with the approval of the Secretary of the Treasury, has prescribed so "as clearly to reflect the income and prevent avoidance of tax liability" by affiliated corporations are indicative of the Government's mature views as to the correct interpretation of provisions in prior acts, like those here involved, that are in all respects similar in substance.

Pursuant to the provision in the 1928 Act the Treasury Department, on January 3, 1929, promulgated regulations 75, which in Article 41 (c) thereof provides:

> "(c) *Net loss sustained by separate corporation prior to consolidated return period.*
>
> A net loss sustained by a corporation prior to the date upon which its income is included in the consolidated return of an affiliated group (including any net loss sustained prior to the taxable year 1929) shall be allowed as a deduction in computing the consolidated net income of such group in the same manner, to the same extent, and upon the same conditions as if the consolidated income

were the income of such corporation; but in no case in which the affiliated status is created after January 1, 1929, will any such net loss be allowed as a deduction in excess of the cost or the aggregate basis of the stock of such corporation owned by the members of the group."

This regulation is an explicit recognition of the deduction here claimed. It is general in terms and without limitation as to those cases where affiliation arose prior to January 1, 1929. As to those where affiliation should be created after January 1, 1929, the regulation (promulgated on January 3, 1929) put the taxpayer on notice that the deduction would be limited as provided in the last clause of the quoted language; but as to those cases where the affiliated status was created prior to January 1, 1929, there had been no notice and there was no attempted limitation. But the regulation is doubly persuasive because it recognizes the principle we have hereinbefore urged, that it is the "consolidated net income of the group," rather than the separate net incomes of the members summarized, that is the objective in the case of a consolidated return. If any doubt were possible, the language of other subdivisions of Article 41 of Regulations 75 shows beyond question that the income of the consolidated group is treated as that of one single tax computing entity—not several separately determined and summarized;—as, for instance, subdivision (b) of the article speaks of and treats the matter "as if such [consolidated] group were a single corporation." Furthermore, the definition of consolidated net income in the regulations, quoted *ante*, page 13, leaves the matter settled as we submit fundamental principles require it to be.

The reasoning of the court below and of the Circuit Court of Appeals for the Second Circuit in their adverse decisions is based on principles contrary to those long established by administrative construction and by decisions of the Board of Tax Appeals, and is directly in conflict with the specific provisions of Article 41 (c) of Regulations 75, as well as the substance of prior regulations.

Taxpayers have been required by the law to give their

consent in advance, by the filing of a consolidated return, to the provisions of the present regulations. Their returns have for several years been filed on that basis. If the court below and the Circuit Court of Appeals for the Second Circuit are correct, these regulations must be illegal. But what other regulation with respect to the matter could be promulgated that would comport with the fundamental theory and intent of a consolidated return? Obviously these regulations are soundly grounded on principle and the court below is without support in law or fundamental theory.

We deem it unnecessary here, and unduly burdensome, to argue supposititious cases that may, and do, arise in the administration of the consolidated returns provisions. Some of those cases are complicated; they can be solved only by following the theory of consolidated returns that, we respectfully submit, is established by the foregoing authorities and that is recognized and promulgated as the Government's construction by the present regulations. If that theory is departed from, no chart or consistent method exists for application to the varying situations that may arise.

CONCLUSION.

For the reasons above set forth the statutory net losses of the Piedmont Savings Company should be allowed as deductions from the gross income of the affiliated group on the consolidated return of the petitioner and Piedmont Savings Company, and the judgment of the Circuit Court of Appeals should be reversed.

Respectfully submitted,

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